

Assonime-CEPS-Unicredit  
Task Force on Banking Crisis Resolution Procedures

Bank crisis management in the EU:  
overview of the issues

Stefano Micossi

Brussels, 17 July 2009

## Special features of bank crises

- Trouble may develop very rapidly, and spread from bank to bank as confidence evaporates
- If depositors are unsure that they will maintain full access to their deposits, a bank run will develop immediately
- Therefore corrective action must start early and operate radically and swiftly
- Instability and cost to taxpayers reduced if intervention takes place before capital is depleted

## Policy tools

1. Crisis prevention: prudential regulation (including capital requirements, effective supervision, market discipline), and deposit insurance
2. Crisis management: general liquidity support, lending of last resort, prompt corrective action
3. Bank crisis resolution: reorganization, winding up

## Crisis prevention: prudential tools

- (i) Capital requirements (Pillar 1): risk weighted or total leverage (as in IMF 2009); liquidity cushions, funding ratios?
- (ii) Supervisory standards (Pillar 2): common core principles, but broad discretion in rule implementation and enforcement leading to different rule-books
- (iii) Market discipline (Pillar 3): information disclosure; loss recognition, stress tests?
  - Home country responsible for solvency on consolidated basis
  - Host country authorises subsidiaries and is responsible for supervision and solvency on solo basis, as well as liquidity of branches

## Crisis prevention: deposit insurance

- Key issues:
  - (i) Coverage: 100% rather than only retail deposits (up to fixed amount); need to ensure prompt availability of funds to depositors
  - (ii) Funding: private pre-funded (adequacy?), public top-up (under what circumstances), public
  - (iii) Managing crises: what authority, with what powers, under what procedures
  - (iv) when crisis cross-border, what coverage for depositors with foreign banks, who pays?

## Gaps in crisis management in the EU for cross-border financial institutions

- According to ECB there are 46 cross-border groups, for about 70% of EU banking assets; 16 groups hold around one third of total assets
- In a number of cases banking system relatively large relative to fiscal capacity and GDP
- Crisis management typically national, tightly linked to fiscal powers
- No common system for cross-border crisis management and sharing attendant burdens
- Special insolvency regimes for banks exist only in some countries, others only have general bankruptcy procedures

## Some fundamental issues

- For cross-border institutions, different supervisory, crisis management and resolution tools prevent orderly and efficient action
- Goal conflict between supervisors; more serious when asymmetry of exposure: i.e. when what is systemically important for one supervisor is less important for others, leading to different assessment of urgency to act and type of response
- High risk of distortions in uncoordinated (opaque) interventions: capital injections, public guarantees on bank liabilities or assets, bad banks and other tools to handle “toxic” assets

## Crisis management: the US system of PCA

- Special insolvency regime for depository institutions managed by the deposit insurance agency, the FDIC
- Open issue: bank holding companies and non-depository institutions not covered
- Prompt corrective action (PCA), with mandated action at predetermined thresholds of capital and other criteria
- Main goal: to minimize losses of deposit insurance fund (rather than stability of institutions)
- Undercapitalized banks are closed before economic value of their capital falls below zero

## Mandated steps in PCA: an example

- Adequately capitalized: no capital distribution or management bonuses that would cause the bank to become undercapitalized; special supervisory attention as capital buffers reduced
- Undercapitalized: dividends and management bonuses suspended, capital restoration plan, other restrictions (branching, new lines of business, transactions with affiliates, rates payable on deposits, etc.)
- Critically undercapitalized: mandatory capital issuance, payments on subordinated debt prohibited, conservatorship or receivership within fixed term unless capital restored

## Key ingredients of PCA at EU level

- Allocation of powers to supervise and to act: what banks, what institutions to empower to act, what actions - an EDIC?
- Incentives: commitment to (i) avoid supervisory forbearance; (ii) remove management and punish shareholders; (iii) mandated corrective action before capital falls too low
- Automatic “triggers”: stock price, market risk measures, capital and leverage
- Common support tools (as recommended by FSB): data on cross-border banks fully and timely disseminated by home country to relevant host countries authorities; a common document for assessing systemic implications and handling crises

## Bank crisis resolution in the EU: key issues

- Geographical misalignment: cross-border banks global in life, but national in death – fiscal support national
- Different legal systems: special insolvency regimes in Italy, Norway, Denmark, Greece, Switzerland, US, now also UK; general corporate bankruptcy law in Austria, Belgium, France, Finland, Germany, Netherland, Luxembourg, Ireland
- Authority to commence proceedings: in special procedures, either court based or entrusted to administrative body under administrative procedures
- Treatment of interested parties, contract close-out and set-off rules different between MS, and different yet between special procedures and normal bankruptcy
- Role of judicial review

## Conclusions of Basel Group on Cross-border Bank Resolution (CBRG 2007)

- Existing resolution arrangements are not designed to resolve failures of cross-border complex financial institutions – key tools (e.g. bridge bank, M&A, close-out and netting practices) do not work cross border
- Even at national level, existing arrangements are entity-centered and do not allow coordinated resolution of financial groups
- Different legal and substantive priorities of resolution arrangements - emphasis on preservation of domestic interests impedes effective cross-border solutions
- Constrained access to information in a crisis